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Practice

Overview: Indirect Methods of Determining Taxable Income

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There are various audit and investigative techniques available to corroborate or refute a taxpayer's claim about their business operations or nature of doing business. IRS audit or investigative techniques for a cash-intensive business might include an examiner determining that a large understatement of income could exist based on return information and other sources of information. The use of indirect methods of proving income, also referred to as the IRS Financial Status Audit Techniques (FSAT), is not prohibited by Code Sec. 7602(e).[1]

If the examiner has a reasonable indication that unreported income exists, the IRS has the authority to use an indirect method of reconstructing income to determine whether or not the taxpayer has accurately reported total taxable income received. The indirect method need not be exact, but must be reasonable in light of the surrounding facts and circumstances.[2] The use of an indirect method to make the actual determination of tax liability is not a substitute for reconciling whatever books are maintained by the taxpayer to the tax return. The use of a "formal" indirect method, however, is not precluded by the presentation of books and records.[3]

Use of a formal indirect method is often supported by circumstances that, individually or in combination, would support: (1) a financial status analysis that cannot be balanced; *i.e.,* the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference; (2) irregularities in the taxpayer's books and weak internal controls; (3) gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry; (4) the taxpayer's bank accounts have unexplained items of deposit; (5) the taxpayer does

not make regular deposits of income, but uses cash instead; (6) a review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income; (7) there are no books and records (examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, determine who destroyed them, why, and when); or (8) no method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income.[4]

Indirect Methods of Determining Income

Indirect methods include a fully developed Cash T, percentage mark-up, net worth analysis, source and application of funds or bank deposit and cash expenditures analysis. However, examiners must first establish a reasonable indication that there is a likelihood of underreported or unreported income. Examiners must then request an explanation of the discrepancy from the taxpayer. If the taxpayer cannot explain, refuses to explain, or cannot fully explain the discrepancy, a FSAT may be necessary. Common FSATs include the following.

The Source and Application of Funds Method

The Source and Application of Funds Method is an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period.[5] This method is based on the theory that any excess expense items (applications) over income items (sources) represent an understatement of taxable income. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income. The Source and Application of Funds Method is typically used when the review of a taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported, the taxpayer's cash does not all flow from a bank account which can be analyzed to determine its source and subsequent disposition, or the taxpayer makes it a common business practice to use cash receipts to pay business expenses.

Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Unreported sources of income, even though known, are not listed in this computation since the purpose is to determine the amount of any unreported income. Specific items of income are denoted separately. Specific sources of funds include the decrease in cash-on-hand, in-bank account balances (including personal and business checking and savings accounts) and decreases in accounts receivable; increases in accounts payable; increases in loan principals and credit card balances; taxable and nontaxable income, and deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold.

Applications of funds are ways the taxpayer used (or expended) money during the year. Examples of applications of funds include increases in cash-on-hand, increase in bank account balances (including personal and business checking and savings accounts), business equipment purchased, real estate purchased and personal assets acquired; purchases and business expenses; decreases in loan principals and credit card balances, and personal living expenses.

Taxpayers often attempt to refute the findings of the examiner's formal indirect method by claiming the unexplained difference is actually caused by the use of nontaxable funds accumulated in prior years. Determining the beginning amount of cash-on-hand and accumulated fund for the year is important.[6] As such, examiners attempt to establish the amount and verify the taxpayer's statements of cash accumulations during an initial interview of the taxpayer. The term cash-on-hand means any un-deposited currency and coins used for normal business transactions. "Accumulated funds" refers to cash accumulated by the taxpayer and not associated with normal business practices and/or transactions with customers. The funds may have been taxed in prior years, originate from nontaxable sources, or may represent taxable income in the year under audit.

If taxpayers allege that they have what appears to be an inordinate amount of cash, the examiner will further inquire to establish the amount of cash-on-hand at the end of each year under examination to the present (at the time of the interview); how it was accumulated; where it was kept and in what denominations; who else had knowledge of it; who

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counted it; when and where any of it was spent; and why did the taxpayer accumulate the cash-on-hand.[7] Common interview questions attempting to establish the amount of cash on hand include the following:

(1) Do you keep more than $1,000 on your person, at your home, at your business or in any other location?
(2) What do the accumulated funds consist of (for example, paper money, coin, money orders, cashier checks, *etc.*)?
(3) In what denominations were the funds accumulated?
(4) Where do you keep the accumulated funds? (Provide exact location.)
(5) Were the accumulated funds always kept in the location identified in question 4? If not, provide the exact locations and dates that the accumulated funds were kept there.
(6) What kind of container were the accumulated funds kept in (shape and dimensions of the container)?
(7) How much in accumulated funds did you have at the beginning of the year under audit? At the end of the year under audit?
(8) How much in accumulated funds do you have right now (today's date)?
(9) Over what period of time were the funds accumulated?
(10) Are the accumulated funds yours alone, or do they belong to more than one person? Identify each person (name and relationship to taxpayer) having ownership of these accumulated funds.
(11) Do any of the other owners have access to these accumulated funds? If yes, provide the following information:
    (a) Name of person with access
    (b) Date of each access
    (c) Identify the increase or decrease in accumulated funds for each access
    (d) Determine whether each person obtaining access was accompanied by another person; if so, provide the name and relationship of such person(s)
    (e) Identify the type of records kept to identify the name(s), date(s) and effect on the accumulated funds each time there was an access
(12) Why are you accumulating funds? (Ask each person having ownership.)
(13) What is the original source of the money included in the accumulated funds? (Ask each person having ownership.)
(14) How often do you access the accumulated funds?
(15) What is the effect of each access? Do you add or withdraw from the accumulated funds?
(16) Are you accompanied by another individual when you access the accumulated funds? If yes, provide the name and address of the persons involved.
(17) Do you count the accumulated funds every time you access them? If not, provide the dates and purpose for when the funds were counted.
(18) Does anyone else know about the accumulated funds? If yes, provide the name, relationship, address, and phone number for the person. Also determine whether these persons have access to the accumulated funds and if so, the manner and circumstances under which their access was made.[8]

The Bank Account Analysis

The Bank Account Analysis compares total deposits with the reported gross income for all accounts, whether designated as personal or business. The examiner will review the taxpayer's business and personal bank accounts (including investment accounts)—*i.e.,* statements, deposit slips and canceled checks, *etc.*—looking for unusual deposits (size or source), the frequency of deposits, deposits of cash, specific deposits that do not follow the taxpayer's normal routine or pattern, nontaxable deposits such as loans and transfers, commingling of personal and business activities, and cash-backs when a deposit occurs.

The examiner will attempt to total the deposits and reconcile deposits of nontaxable funds and transfers between accounts focusing on transfers in, out, and between accounts as previously unknown accounts may be identified. Checks deposited by the taxpayer but later returned by the bank (*e.g.,* the maker of the check did not have sufficient funds in the account to pay the check) are categorized as nontaxable transactions. Nontaxable funds, transfers-in, and returned deposits need to be subtracted from total deposits to get "taxable deposits." The examiner will determine disbursements by adding the opening bank balance to the total deposits and then subtracting out the ending balance.

To the extent possible, cancelled checks will be reviewed to determine whether nondeductible expenditures (personal expenses, investments, payments on asset purchases, *etc.*) are included with business expenses and if so, the amount. If cancelled checks are unavailable, transactions will be traced from the bank statement to the check register and

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the original document. Significant commingling of accounts may warrant a more in-depth analysis by the examiner. When nondeductible expenditures are deducted from the total disbursements the remainder should approximate the deductible business expenses on the tax return (other than noncash expenses such as accruals and depreciation).

If the analysis results in the identification of excess deposits over the reported gross income, the excess represents potential unreported income. If specific transactions or deposits can be identified as the source of the understatement, the examiner may assert a specific item adjustment to income supported by the direct evidence of excess deposits. If the specific transactions or deposits creating the understatement are not identified, an adjustment to taxable income may be made based on the circumstantial evidence. If the business expenditures paid by check are less than the deducted business expenses on the return, then the taxpayer may be overstating expenses, paying expenses by cash (unreported income), or paying expenses from an undisclosed source of funds. If the analysis indicates significant commingling of funds, then the internal controls are weak and the books and records may be unreliable.

The reality is that the IRS's vigorous enforcement efforts aimed at combating offshore tax evasion has bolstered voluntary compliance and the collection of a significant amount of taxes, interest, and penalties.

The Bank Deposits and Cash Expenditures Method

The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by the depth and analysis of all the individual bank account transactions, and the accounting for cash expenditures, and a determination of actual personal living expenses. The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds based on the theory that if a taxpayer receives money it can either be deposited or it can be spent.[9] This method is based on the assumptions that proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitute evidence of taxable receipts and expenditures, as disclosed on the return, were actually made and could only have been paid for by credit card, check or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for and it is the burden of the taxpayer to demonstrate a nontaxable source for this cash.

The examiner will consider whether there are unusual or extraneous deposits which appear unlikely to have resulted from reported sources of income? The examiner may limit the examination to large deposits or deposits over a certain amount. However, the identification of smaller regular deposits may be indicative of dividend income, interest, rent, or other income, leading to a source of investment income. An item of deposit may be unusual due to the kind of deposit, check or cash, in its relationship to the taxpayer's business or source of income. An explanation may be required if a large cash deposit is made by a taxpayer whose deposits normally consist of checks. Also, a bank statement noting only one or two large even dollar deposits, in lieu of the normal odd dollar and cents deposits, would be unusual and require an explanation.

Many taxpayers, due to the nature of their business or the convenience of the depository used, will follow a set pattern in making deposits. Deviation from this pattern may be reason for more in depth questioning. Bank statements or deposit slips which indicate repeat deposits of the same amount on a monthly basis, quarterly or semi-annual basis may indicate rental, dividend, interest or other income accruing to the taxpayer.

The examination of deposit slips may indicate items of deposit which appear questionable due to the location of the bank on which the deposited check was drawn. It is common practice when preparing a deposit slip to list either the name of the bank, city of the bank or identification number of the bank upon which the deposited check was drawn. If an identification number is used, the name and location of the bank can be determined by reference to the banker's guide. In all cases, if the location of the bank on which the check for deposit was drawn bears little relation to the taxpayer's business location or source of income, it may indicate the need for further investigation.

The examiner will attempt to identify all loan proceeds, collection of loans, or extraneous items

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reflected in deposits. If loan proceeds are identified, the examiner may request the loan application documents to verify the source and amount of the nontaxable funds and attempt to determine whether such information is consistent with other information; i.e., cash flows, assets, anticipated gross receipts, *etc.*

If repayments of loans are identified, the examiner will request the debt instruments to establish that a loan was made, the terms of the debt, and the repayment schedule. Before an examiner can reach any conclusion about the relationship between deposits and reported receipts, transfers and redeposits must be eliminated. For example, if a taxpayer draws a check to cash for the purpose of cashing payroll checks and then redeposits these payroll checks, the examiner would be incorrect if total deposits were compared to receipts reported without adjusting for this amount. The taxpayer has done nothing more than redeposit the same funds in the form of someone else's checks.

The Markup Method

The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts.[10] By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.

The Markup Method is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on actual markup. The Markup Method is often used when inventories are a principal income producing factor and the taxpayer has nonexistent or unreliable records or the taxpayer's cost of goods sold or merchandise purchased is from a limited number of sources such that these sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales prices.

The Net Worth Method

The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a tax year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures and nontaxable sources of funds during the relevant period.

The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities. The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of the income which is partially or wholly nontaxable.

The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income. The use of the Net Worth Method of proof requires that the government establish an opening net worth, also known as the base year, with reasonable certainty; negate reasonable explanations by the taxpayer inconsistent with guilt; *i.e.,* reasons for the increased net worth other than the receipt of taxable funds. Failure to address the taxpayer's explanations might result in serious injustice; establish that the net worth increases are attributable to currently taxable income, and; where there are no books and records, willfulness may be inferred from that fact coupled with proof of an understatement of taxable income. But where the books and records appear correct on their face, an inference of willfulness from net worth increases alone might not be justified. The government must prove every element beyond a reasonable doubt, though not to a mathematical certainty.

Summary

Circumstances that might support the use of an indirect method include a financial status analysis that cannot be easily reconciled - the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable

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sources of funds have not been identified to explain the difference; irregularities in the taxpayer's books and weak internal controls; gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry; the taxpayer's bank accounts have unexplained deposits; the taxpayer does not make regular deposits of income, but uses cash instead; a review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income; there are no books and records (examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, the examiner will attempt to determine who destroyed them, why, and when); no method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income as required by Code Sec. 446(b).

When considering an indirect method, the examiner will look to the industry or market segment in which the taxpayer operates, whether inventories are a principle income producing activity, whether suppliers can be identified and/or merchandise is purchased from a limited number of suppliers, whether pricing of merchandise and/or service is reasonably consistent, the volume of production and variety of products, availability and completeness of the taxpayer's books and records, the taxpayer's banking practices, the taxpayer's use of cash to pay expenses, expenditures exceed income, stability of assets and liabilities, and stability of net worth over multiple years under audit.

Endnotes

1 Code Sec. 7602(e) states that "the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income."

2 *M.L. Holland,* SCt, 54-2 USTC ¶9714, 348 US 121, 134, 75 SCt 127.

3 *See M. Lipsitz,* 21 TC 917, Dec. 20,212 (1954).

4 *See* Code Sec. 446(b).

5 *See W.R. Johnson,* SCt, 43-1 USTC ¶9470, 319 US 503, 63 SCt 1233 (in addition to proving the taxpayer owned gambling establishments whose winnings were unreported, it was proven that in three of the years involved, the taxpayer's personal expenditures exceeded his current income plus his declared accumulated funds).

6 *See* IRM 4.10.4.6.8.3 (Aug. 9, 2011) for possible defenses the taxpayer might raise regarding the availability of nontaxable funds.

7 IRM 4.10.4.6.8.3 (Aug. 9, 2011).

8 IRM Exhibit 4.10.4-1.

9 *See L.M. Gleckman,* CA-8, 35-2 USTC ¶9645, 80 F2d 394. The court held that standing alone bank deposits and large items of receipts do not prove additional tax due. On the other hand, if it is shown that these amounts can be associated with a business or income-producing activity, then the income is taxable. In order to use the Bank Deposits and Cash Expenditures Method in determining income, it must be shown that: (1) the taxpayer was engaged in a business or income-producing activity; (2) the taxpayer made periodic deposits of funds into a bank account or accounts; (3) an adequate investigation of deposits was made by the examiner in order to negate or eliminate the likelihood that the deposits arose from nontaxable sources of income, and (4) unidentified bank deposits have the inherent appearance of income; *i.e.,* the size of the deposits, odd or even amounts, source of checks deposited, dates of deposits, *etc.*

10 *See H. Barragan,* 65 TCM 2091, Dec. 48,905(M), TC Memo. 1993-92 (the IRS properly determined gross receipts from a gas station based on the supplier's delivery records and the retail prices per an independent market survey); *C.E. Stafford,* 64 TCM 1199, Dec. 48,613(M), TC Memo. 1992-637 (the IRS properly determined gross receipts from gas stations based on Bureau of Labor Statistics data); and *Fior D'Italia, Inc.,* SCt, 2002-1 USTC ¶50,459, 536 US 238, 122 SCt 2117 (the majority held that Code Sec. 446(b) does not limit authority to use aggregate estimation of income taxes for unreported tip income).

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